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No. 96-371

In the Supreme Court of the United States

OCTOBER TERM, 1996

ERNEST J. CLAYTON, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether Canadian employees of a United States corporation who receive cash distributions from an employee stock ownership trust maintained in the United States are subject to United States taxation on the portion of the distributions representing appreciation in the value of the underlying stock.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-5a) is unofficially reported at 96-1 U.S.T.C. ¶ 50,314. The opinion of the Court of Federal Claims (Pet. App. 6a-74a) is reported at 33 Fed. Cl. 628.

JURISDICTION

The judgment of the court of appeals was entered on June 12, 1996. The petition for a writ of certiorari was filed on September 10, 1996. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioners are Canadian citizens who were employed by Canadian subsidiaries of Chrysler Corporation during the early 1980's. At various times during this period, petitioners participated in an Employee Stock Ownership Plan (ESOP) established by Chrysler (Pet. App. 2a).[1] From 1981 to 1984, Chrysler contributed shares of its common stock to the Employee Stock Ownership Trust (ESOT) established under the ESOP (*id.* at 10a). In November 1985, the Chrysler ESOP Committee informed Canadian participants that the ESOP was scheduled for termination in January 1986. The Committee advised the participants that, upon termination of the ESOP, the shares of Chrysler stock held in the ESOT would be "'available for distribution' * * * [either] in the form of cash or stock" (*id.* at 11a).

Petitioners, along with 8000 other participants, elected to receive cash distributions from the ESOP.

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[1] The Chrysler ESOP was established pursuant to the Chrysler Corporation Loan Guarantee Act of 1979, Pub. L. No. 96-185, 93 Stat. 1324 (1980). The Act provided for loan guarantees to Chrysler contingent upon that corporation's compliance with various requirements enumerated in the statute. In particular, (i) Section 6 of the Act required Chrysler to obtain wage and benefit concessions from its employees (93 Stat. 1329) and (ii) Section 7 of the Act required Chrysler to establish an employee stock ownership plan satisfying the requirements for qualification under 26 U.S.C. 401(k)(2)(B) for deferred compensation plans and under 26 U.S.C. 4975(e)(7) for ESOPs (93 Stat. 1330-1331). The Act further required Chrysler (i) to establish a trust as part of the ESOP, (ii) to make contributions of shares of common stock totaling at least $162,500,000 over a four-year period to that trust and (iii) to issue additional shares of qualified common stock to the trust at appropriate times in the future (93 Stat. 1330-1331).

The cash distributions were based upon the sales of the Chrysler common stock made by the trustee of the ESOT in December 1985. The sale price was the closing price on the New York Stock Exchange for each sale date. The shares of stock had appreciated in value between the date that they were contributed to the ESOP and the date of sale (Pet. App. 12a).

In January 1986, the trustee remitted the cash proceeds resulting from these sales of stock to petitioners and other plan participants. The cash proceeds included the appreciation in the value of the stock between the date of contribution and the date of sale. From these proceeds, the trustee withheld, for United States income tax, 15 percent of the portion of the cash distribution that represented the appreciation in value of the stock (Pet. App. 13a-14a).[2]

2. a. Petitioners filed timely claims for refund of the amounts withheld as taxes by the trustee. When those claims were denied, petitioners commenced this refund suit in the Court of Federal Claims.[3] Petitioners asserted that the appreciation in the value of the Chrysler stock represents "compensation for services" performed in a foreign country under 26 U.S.C. 862(a)(3)—which provides that United States source

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[2] The trustee did not withhold tax on the portion of the distribution reflecting the value of the stock on the date of contribution. The parties agree that those amounts constitute compensation for services performed by a nonresident alien outside the United States (26 U.S.C. 862(a)(3)) and therefore are not subject to United States taxation under 26 U.S.C. 871(a)(1). See Pet. App. 19a.

[3] The refund suit was brought on behalf of petitioners and 6200 other similarly situated individuals. The parties have agreed to be bound by the court's decision in this case (Pet. App. 15a).

income does not include compensation for labor or personal services performed without the United States—and is therefore not subject to United States taxation under 26 U.S.C. 871(a)(1)—which imposes tax on income from sources within the United States. Petitioners alternatively contended that this income is not subject to United States taxation under Article XV, Cl. 1 of the United States-Canada Income Tax Convention, Sept. 26, 1980, T.I.A.S. No. 11,087 (1986-2 C.B. 258, 264), which provides that "salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State."[4]

b. The Court of Federal Claims held that petitioners are not entitled to a refund of the withheld taxes (Pet. App. 16a-74a). The court rejected petitioners' argument that the appreciation of the contributed stock constitutes compensation for services rendered outside of the United States. The court explained that (i) the Internal Revenue Service has long ruled that the earnings component of a distribution from a trust located in the United States constitutes United States source income and (ii) Congress has approved that general rule in enacting subsequent legislation (*id.* at 44a-62a). The court noted that Congress has enacted three narrow exceptions from the rule that trust income is subject to United States tax and that "[a]ccepting plaintiffs' theory that the earnings and

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[4] Petitioners raised other issues in the Court of Federal Claims that were resolved against them. See Pet. App. 17a-44a, 63a-66a. Those issues are not raised in the petition.

accretions constitute compensation would render these sections superfluous" (*id.* at 52a).

The Court of Federal Claims also held that the appreciation of the value of the contributed stock is not exempt from United States taxation under the United States-Canada Income Tax Convention (Pet. App. 67a-74a). The court concluded that this income does not represent "salaries, wages and other similar remuneration" derived from the exercise of employment within the meaning of Article XV, Cl. 1 of the Convention because (i) the term "salaries, wages and other similar remuneration" is not defined in the Convention, (ii) Article III, Cl. 2 of the Convention provides that the meaning of undefined terms is supplied by the law of the country imposing the tax and (iii) "[d]efining the earnings and accretions as remuneration similar to wages and salary * * * would be inconsistent with established United States tax policy" (Pet. App. 68a). Because the income from the appreciation of the contributed stock is not exempt from tax under the Convention, the court held that it is subject to tax by the United States at the rate of 15 percent under Article XXII of the Convention (Pet. App. 73a), which provides that income distributed by a trust "not dealt with" in other Articles of the Convention may be taxed at a maximum rate of 15 percent by the country of which the trust is a resident.[5]

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[5] If the Convention were not applicable to this income, the amounts at issue would have been subject to a 30 percent withholding tax under 26 U.S.C. 871(a), 881(a). The rate of tax specified in the Convention is applicable in this case because, under 26 U.S.C. 894(a)(1), the provisions of the Internal Revenue Code are to "be applied to any taxpayer with due regard to

4. The court of appeals affirmed (Pet. App. 1a-5a). The court of appeals agreed with the Court of Federal Claims that Congress has adopted the rule that the earnings component of a distribution from an employee trust does not constitute "compensation for services" for purposes of the foreign tax provisions of the Internal Revenue Code (*id.* at 4a). The court of appeals also agreed that this income is not exempt from taxation under the United States-Canada Convention (*id.* at 4a-5a).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. a. Section 871(a)(1) of the Internal Revenue Code imposes a tax on "the amount received from sources within the United States by a nonresident alien individual as * * * interest * * *, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income." 26 U.S.C. 871(a)(1). Section 862(a)(3) specifies that "compensation for labor or personal services performed without the United States" is to "be treated as income from sources without the United States." 26 U.S.C. 862(a)(3).

b. Petitioners err in contending that the appreciation of stock held by a United States trust constitutes "compensation for services" within the meaning of Section 862(a)(3) and is therefore not subject to

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any treaty obligation of the United States which applies to such taxpayer." See also 26 U.S.C. 7852(d)(1).

taxation under Section 871(a)(1). As the courts below correctly held, that contention is foreclosed by the established principle that "Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law." *Cottage Savings Ass'n* v. *Commissioner*, 499 U.S. 554, 561 (1991).

More than forty years ago, the Internal Revenue Service addressed the precise question of the "taxability of distributions under [a stock bonus, pension, profit-sharing or annuity plan established by employers for their employees] where such distributions are to a nonresident and are, in part at least, on account of or with respect to services rendered outside the United States by the employee involved." IR-Mim. 71, 1952-2 C.B. 170. The Service concluded that (1952-2 C.B. at 172); (emphasis added):

> a distribution under or pursuant to a stock bonus, pension, profit-sharing, or annuity plan by a domestic trust or insurance company to a nonresident citizen or nonresident alien is excludable from the gross income of the recipient only to the extent the payment represents (*a*) a return of the employee's own contributions or (*b*) amounts actually contributed by the employer on account of personal services of the employee rendered abroad * * *. *To the extent such payments represent earnings on and accretions to contributions of either the employer or the employee, they constitute income from sources within the United States and accordingly are includible in gross income unless expressly*

excludable pursuant to the provisions of an income tax convention.

In 1956, the Service further specifically ruled that the portion of an annuity payment that represents earnings on contributions by the employer for services rendered in a foreign country is not exempt from United States taxation as compensation for services without the United States. Rev. Rul. 56-125, 1956-1 C.B. 627. That Ruling was reiterated in 1979 in Rev. Rul. 79-388, 1979-2 C.B. 270.

As the court of appeals correctly concluded (Pet. App. 4a), Congress necessarily approved this general trust source rule when it enacted three specific exceptions to the general rule in subsequent legislation.[6] As the Court of Federal Claims correctly observed (Pet. App. 46a-54a), the legislative histories

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[6] See Act of Apr. 22, 1960, Pub. L. No. 86-437, § [1], 74 Stat. 79 (adding what is now Section 402(e)(2) to the Code to provide a pro rata exclusion from gross income for civil service retirement benefits paid by the United States from an exempt trust to nonresident aliens); Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, § 103(a)(1), 80 Stat. 1549 (adding Section 871(f) to the Code to exclude from gross income the amount of any annuity received under a qualified plan if (i) the annuity stemmed from personal services rendered by a nonresident alien outside of the United States and (ii) at least 90 percent of the employees for whom contributions are provided under the plan are citizens or residents of the United States at the time the first amount is paid under the plan); Miscellaneous Revenue Act of 1980, Pub. L. No. 96-605, § 227(a), 94 Stat. 3530 (broadening the exception in Section 871(f) to include annuity payments received by individuals whose country of residence (i) grants a substantially equivalent exclusion to residents and citizens of the United States or (ii) is a beneficiary developing country within the meaning of Section 502 of the Trade Act of 1974, 19 U.S.C. 2462).

of these statutes clearly demonstrate that Congress was aware of, and approved, the general rule announced in IR-Mim. 71.[7] In this context, the court of appeals properly held that the income involved in this case constitutes United States source income and is therefore subject to United States tax.[8] See *United States* v. *Sheffield Board of Commissioners*, 435 U.S. 110, 134 (1978) ("When a Congress that re-enacts a statute voices its approval of an administrative or other interpretation thereof, Congress is treated as having adopted that interpretation, and this Court is bound thereby."); J. Harllee, Jr., *U.S. Income Taxation of Aliens on Current and Deferred Compensation*, *in* 1 New York University 37th Annual Institute on Federal Taxation 21-1, at 21-31 (1979) ("Congress has confirmed the general validity of [the situs of the trust source rule] by * * * providing narrow statutory exceptions.").[9]

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[7] See S. Rep. No. 1028, 86th Cong., 2d Sess. 2 (1960); S. Rep. No. 1707, 89th Cong., 2d Sess. 27 (1966); S. Rep. No. 1036, 96th Cong., 2d Sess. 37 (1980).

[8] Petitioners err in contending (Pet. 13) that, in enacting Sections 402(e)(2) and 871(f) of the Internal Revenue Code, Congress approved the situs of the trust source rule for pensions and annuities but not for lump sum payments from qualified trusts. The situs of the trust source rule is predicated upon the location of the trust, not on the type of distribution from the trust. As the Court of Federal Claims observed, the rule "applie[s] to all qualified plan distributions, not just annuities" (Pet. App. 48a).

[9] Petitioners assert (Pet. 11-15) that the doctrine of legislative reenactment is inapplicable to this case because the administrative rule was initially announced in a "nonbinding" mimeograph, as opposed to a revenue ruling. That contention plainly lacks substance, for the rule described in IR-Mim. 71 was formally adopted and applied in formal Revenue Rulings issued

c. Petitioners err in contending (Pet. 8-11) that the decision in this case conflicts with decisions of other courts of appeals. None of the cases cited by petitioners addresses the question presented in this case.[10] Indeed, the question whether the appreciation in the value of stock held by an employee trust constitutes United States source income when that income is realized by the sale of the stock and the proceeds of that sale are distributed to foreign

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in 1956 and 1979. See Rev. Rul. 56-125, 1956-1 C.B. at 628-629; Rev. Rul. 79-388, 1979-2 C.B. at 271.

[10] These cases are *Frazer* v. *Commissioner*, 157 F.2d 282 (6th Cir. 1946), cert. denied, 329 U.S. 807, *Kaufmann* v. *Commissioner*, 173 F.2d 225 (6th Cir. 1949), *Monte Vista Burial Park, Inc.* v. *United States*, 340 F.2d 595 (6th Cir. 1965), *Metairie Cemetary Association* v. *United States*, 282 F.2d 225 (5th Cir. 1960), *Sheet Metal Workers Local 141 Supplemental Unemployment Benefit Trust Fund* v. *United States*, 64 F.3d 245 (6th Cir. 1995), cert. denied, 116 S. Ct. 713 (1996), *Lane Processing Trust* v. *United States*, 25 F.3d 662 (8th Cir. 1994), *NYSA-ILA Container Royalty Fund* v. *Commissioner*, 847 F.2d 50 (2d Cir. 1988), and *STA of Baltimore-ILA Container Royalty Fund* v. *United States*, 804 F.2d 296 (4th Cir. 1986). The petition (Pet. 10) also cites two cases from this Court, *Commissioner* v. *Smith*, 324 U.S. 177 (1945), and *United States* v. *Basye*, 410 U.S. 441 (1973), but does not appear to contend (and would have no basis for contending) that the decision below conflicts with these cases.

Petitioners' suggestion (Pet. 10) that the income involved in this case constitutes "wages" for purposes of domestic tax withholding is wrong. Section 3401(a)(12) of the Internal Revenue Code provides that the term "wages" for purposes of domestic tax withholding does not include remuneration to an employee from a qualified trust unless the individual is an employee of the trust. The various appellate decisions cited in the petition that characterized distributions to employees as "wages" (*e.g.*, *Lane Processing Trust* v. *United States*, *supra*) did not involve qualified trusts.

employees was an issue of first impression in this case.

2. Petitioners do not contend that the interpretation of the United States-Canada Income Tax Convention by the court of appeals conflicts with the decision of any other appellate court. Instead, petitioners assert only that the court of appeals misinterpreted that Convention in this case (Pet. 17-20). That assertion does not warrant further review.

The court of appeals correctly held that the income involved in this case is taxable at a 15 percent rate under Article XXII of the Convention. That Article provides that, when income that arises in one Contracting State is distributed from "an estate or trust which is a resident of [that] Contracting State to a resident of the other Contracting State who is a beneficiary of the estate or trust," such income may be taxed at a rate that "shall not exceed 15 per cent of the gross amount of the income" (1986-2 C.B. at 266). As the court of appeals concluded (Pet. App. 4a), the income involved in this case falls squarely within this Article of the Convention.

Petitioners assert, however, that this income should be exempt from United States taxation under Article XV, Cl. 1 of the Convention, which provides that "salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State."[11] As the court of appeals cor-

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[11] The Model Tax Convention of the Organization for Economic Cooperation and Development, on which petitioners rely (Pet. 17-20), provides no support for petitioners' contention that the term "salaries, wages and other similar remuneration"

rectly observed, however, petitioners err in claiming that the income involved in this case constitutes "similar remuneration" within the meaning of this Article (Pet. App. 4a-5a):

> [Petitioners'] distributions, however, do not clearly fall within any defined category of the Treaty. Article III of the Treaty establishes that whenever the Treaty does not define a term, its meaning must come from the country imposing the tax. Under United States tax policy, remuneration does not include the earnings and accretions of qualified trust distributions to nonresident aliens. Thus, [petitioners'] distributions are not wages, salary, or compensation for services performed under Article XV.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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encompasses the earnings component of a distribution from a qualified employee trust. This case involves the interpretation of the actual provisions of the United States-Canada Income Tax Convention, not of any "model" convention.